# Tax Expenditure Report



1997-98

## Introduction

The Department of Finance has been required to produce a tax expenditure report since 1971. Chapter 1762, Statutes of 1971, required that a biennial report be submitted to the Legislature. Chapter 1286, Statutes of 1984, added Section 13305 to the Government Code and increased the reporting frequency from once every two years to once a year. This report fulfills the Department's statutory requirement pursuant to Government Code Section 13305.

## Definitions

There is no absolute rule for defining tax expenditures, and the concept of a "tax expenditure" can be defined in several different ways. For the purposes of this report, the Department has chosen to define a tax expenditure as any special provision in the tax law that results in collection of fewer tax revenues than would be collected under the basic tax structure. This report is also intended to identify tax expenditures that carry large revenue impacts in order to focus attention on those areas of the tax structure with major fiscal significance.

Although broad, this definition does exclude several provisions of the tax law from inclusion as tax expenditures.

- Because the basic structure of each tax is used as the starting point for determining what constitutes a tax expenditure, elements of the basic tax structure that exempt certain groups are not considered tax expenditures. For example, the sales tax is imposed on retailers for the privilege of selling tangible personal property at retail. According to its basic definition, California's sales tax does not apply to sales or leases of real property, sales of services, wholesale transactions, or sales of securities and insurance. These exemptions are therefore not considered tax expenditures; they are elements of the basic tax structure.

- Across-the-board tax rate reductions do not represent tax expenditures. Tax expenditures resulting from changes in the rate structure only exist if different sets of rates are applied to a similar base.

- Progressive rate structures do not constitute tax expenditures. The basic structure of California's income tax is progressive. For that reason, application of different tax rates to different income levels is a basic characteristic of the tax and does not represent a tax expenditure.

- Exemptions or exclusions required by the U.S. Constitution or federal laws are not considered tax expenditures.

- Changes in tax law that alter penalties or interest or that accelerate or defer tax payments are generally not considered tax expenditures unless they are very narrowly targeted.

However, the definition of "tax expenditure" is subject to debate, and there is no single rule for determining what constitutes an element of the basic tax structure or defining how costly an expenditure must be for inclusion. For these reasons, items may be excluded in this report that are included in other tax expenditure reports and vice versa.

## *Why Adopt Tax Expenditures*

Tax expenditures may be classified into the following four broad groups:

- Those which conform California tax law to federal provisions,

- Those intended to remove perceived inequities in the basic tax structure,

- Those intended to ease tax administration, and

- Those which grant targeted tax reductions through exemptions, credits, deductions, or exclusions.

There are several differences between tax expenditures and direct expenditures (those authorized through the budget process). First, tax expenditures are reviewed less frequently than direct expenditures once they are in place. This can offer taxpayers more certainty than they would have if tax expenditures were subject to annual review but can also result in certain tax expenditures remaining in the tax code long after they have outlived their usefulness.

In general, there is also no control over the amount of foregone revenue that results from a tax expenditure once that provision has become part of the tax code.

Finally, the vote requirements for tax expenditures and direct expenditures are different. Tax expenditures that are adopted legislatively (except those adopted as urgency measures) require approval by a simple majority of both houses of the Legislature. A two-thirds vote is required for budgetary appropriations.

## *Dynamics of Tax Expenditures*

To provide some view of the dynamics of tax expenditures in the legislative process, Table 1 lists the tax expenditures repealed, and Table 2 lists those enacted since 1990. This report omits programs with an annual cost of under $5 million in an effort to focus on tax expenditures of fiscal significance.

## *Revenue Estimates*

The estimates listed in this report are intended as a general indication of revenue losses from tax expenditure programs. These estimates represent full fiscal year revenue impacts. Thus, if a tax expenditure is enacted part way through a fiscal year, the revenue impact cited is that which resulted during the first *full* year in which the expenditure was effective.

Tables 3 and 4 list the major revenue losses estimated to result from the principal tax expenditures for which estimates can reasonably be developed. Both tables have been limited to displaying tax expenditures of $10 million or more. Examples of lesser expenditures that have been excluded are personal income tax credits for political contributions, the elderly, and the military, and sales tax exemptions for master records and tapes and for bullion.

In general, revenue estimates listed under the personal income tax and bank and corporation tax laws are more readily quantifiable than those listed under the sales and use tax law. This is true because personal income and bank and corporation tax returns contain significant detail regarding different sources of income and types of exemptions, exclusions, deductions, and credits claimed. Thus, tax return data are often available when estimating the fiscal impact of various income and corporate tax expenditure programs. In contrast, returns filed by taxpayers under the sales and use tax law contain little specific information regarding items purchased from individual retailers and include *no* information regarding items not purchased. For this reason, independent data sources must be used when estimating the revenue impacts of various sales tax expenditure programs, and the precision of these estimates can in some cases be lower than the precision of those listed under the personal income and bank and corporation tax laws.

It is also the case that certain estimates under *all* of the tax laws for which tax expenditure costs are cited can be subject to significant margins of error due to data limitations. Other factors complicating the estimates cited herein include the effects of tax law interactions and taxpayer reactions to changes in tax law. Furthermore, while Tables 3 and 4 display the total value of the major identified expenditures within each major tax, these figures are intended as illustrative, only. The fiscal impact of individual tax expenditures cannot be summed to generate the total fiscal impact of all tax expenditures due to the complicating factors of tax law interactions and taxpayer behavioral responses.

## *State Revenue Losses*

### Personal Income Tax

The personal income tax law includes the vast majority of all tax expenditure programs approved to date. It is estimated that special income tax provisions account for over $13 billion in annual tax expenditures.

### Sales and Use Tax

The sales and use tax law contains identifiable tax expenditures worth approximately $1 billion annually. Examples of these include custom computer programs, printed advertising, and motion picture leases.

## Bank and Corporation Tax

Tax expenditures in the bank and corporation category amount to almost $3 billion annually. Examples of these expenditures include provisions for S-corporations and water's edge corporations.

## Other State Taxes

Remaining state tax laws are estimated to contain tax expenditure programs valued at approximately $500 million. Much of this revenue loss results from insurance tax expenditures for nonprofit hospital service plans.

# *Local Revenue Losses*

Table 4 lists revenue losses from the principal exemptions or preferential provisions of property tax law. Property taxes are local taxes, and the legislative exemptions or preferential provisions do not constitute state tax expenditures. Nonetheless, they impact State finances because local tax exemptions reduce property tax allocations to schools. California is generally required, under current school finance law, to provide the difference in funding between local property tax allocations and school districts' revenue limits. Consequently, each dollar of property tax revenue foregone by schools results in an additional dollar of state funding through the school apportionment process. Passage of Proposition 98 in November 1988 further impacts state school financing by establishing minimum funding levels for public schools and community colleges, based on both property taxes and state funding. Some property tax exemptions result in state subventions to local governments other than school entities in order to make up some or all of their revenue losses.

Local government revenue losses from identifiable property tax exemptions are estimated at slightly under $250 million, while losses from sales tax expenditures are estimated at approximately $650 million.

## *Unidentifiable Revenue Loss Areas*

It is not always possible to quantify the revenue loss of a particular tax expenditure. Fortunately, in most instances, those tax expenditures whose revenue impact cannot be estimated represent unique situations and probably do not result in significant revenue losses. Some examples of tax expenditures for which revenue losses cannot be quantified include sales tax exemptions for livestock and meals furnished by institutions and property tax exemptions for intangibles and air carrier ground time.

## Table One



### State Tax Expenditures with Savings of $5 Million or More Eliminated Since 1990—Dollars in Thousands

| Year Enacted | Chapter | Description | First Full Year Cost |
|---|---|---|---|
| **1990** | **Non** | | |
| **1991** | | **Personal Income Tax** | |
| | 117 | Reduce itemized deductions for high income taxpayers | $248,000 |
| | | **Sales and Use Tax**[1] | |
| | 85 | Common carrier fuel (rail and aircraft)[2] | 106,000 |
| | 85 | Newspapers | 57,000 |
| | 85 | Non-subscription periodicals[3] | 30,000 |
| **1992** | | **Personal Income Tax** | |
| | SS | Child care credit provisions expired December 31, 1992 | 106,000 |
| **1993** | | **None** | |
| **1994** | | **None** | |
| **1995** | | **Personal Income Tax** | |
| | SS | Ridesharing expenses credit expired December 31, 1995 | 13,000 |
| **1996** | | **None** | |

SS=Sunset

[1] Chapter 85, Statutes of 1991, also repealed the exemptions for candy, snack foods, and bottled water. However, these exemptions were reinstated in November 1992 by Proposition 163.

[2] Chapter 85, Statutes of 1991, repealed the exemptions for air, rail, and watercraft common carrier fuel. Chapter 905/92 reinstated the exemption for watercraft common carrier fuel and reinstated a partial exemption for aircraft common carrier fuel used on international flights.

[3] Chapter 85, Statutes of 1991, repealed the exemption for all periodicals. Chapter 903/92 reinstated the exemption for subscription periodicals.

# Table Two

## State Tax Expenditures of $5 Million or More Enacted Since 1990—Dollars in Thousands

| Year Enacted | Chapter | Description | First Full Year Cost |
|---|---|---|---|
| **1990** | | **Personal Income Tax** | |
| | 1347 | Stay at home parent credit | $25,000 |
| | | **Bank and Corporation Tax** | |
| | 1513 | Increased compliance penalties | 5,000 |
| **1991** | | **Personal Income Tax** | |
| | 117 | Extension of net operating loss (NOL) carryover[1] | 45,000 |
| | | **Bank and Corporation Tax** | |
| | 117 | Extension of net operating loss (NOL) carryover[1] | 164,000 |
| | 117 | Extension of research and development credit | 64,000 |
| | | **Sales and Use Tax** | |
| | 461 | Newspapers and periodicals distributed free of charge | 20,000 |
| **1992** | | **Personal Income Tax and Bank and Corporation Tax** | |
| | 17 | Establishment of revitalization zone for L.A. riot area | 7,000 |
| | | **Sales and Use Tax** | |
| | 905 | Watercraft common carrier fuel | 21,000 |
| | 903 | Subscription peridicals | 10,000 |
| **1993** | | **Personal Income Tax** | |
| | 881 | Manufacturers' investment credit | 32,000 |
| | 874 | Limited partnerships investment source rule | 10,000 |
| | 881 | Small business stock[2] | Unknown |
| | | **Bank and Corporation Tax** | |
| | 881 | Manufacturers' investment credit | 365,000 |
| | 1121 | Expands credit union income exemption | 13,000 |
| | | **Sales and Use Tax** | |
| | 881 | Manufacturing equipment for start-up firms | 10,000 |
| | 887 | Intangible rights | Unknown |
| **1994** | | **Bank and Corporation Tax** | |
| | 748 | Extends and limits the employer child care credit | 5,000 |

1 The use of net operating loss (NOL) carryovers was suspended for the 1991 and 1992 tax years, and the sunset was extended for 5 years. The costs represent the first year of extension. AB 34 (Ch. 880/93) repealed the sunset date.

2 No fiscal impact until 1998.

# TABLE TWO



## STATE TAX EXPENDITURES OF $5 MILLION OR MORE ENACTED SINCE 1990—DOLLARS IN THOUSANDS

| YEAR ENACTED | CHAPTER | DESCRIPTION | FIRST FULL YEAR COST |
|---|---|---|---|
| **1995** | | None | |
| **1996** | | **Personal Income Tax** | |
| | 954 | Educational assistance exclusion | $ 7,000 |
| | 954 | Medical savings accounts | 8,000 |
| | 954 | Increase in spousal IRAs | 8,000 |
| | 954 | Long-term care deduction | 9,000 |
| | | **Bank and Corporation Tax** | |
| | 953 | Expands Enterprise Zone program | 10,000 |
| | 954 | Expands research and development tax credit | 22,000 |
| | 954 | Reduces minimum franchise tax for new businesses | 8,000 |
| | | **Insurance Tax** | |
| | 967 | Coverage Provided through Ca. Earthquake Authority | 30,000 |

# TABLE THREE

## MAJOR IDENTIFIABLE STATE TAX EXPENDITURES OF $10 MILLION OR MORE, 1997-98—DOLLARS IN MILLIONS

| PERSONAL INCOME TAX | FULL YEAR COST |
|---|---|
| Home mortgage interest deduction | $2,620 |
| Exclusion of pension contributions and earnings | 2,500 |
| Exclusion of employer contributions to health plans | 1,900 |
| Exclusion of Social Security benefits | 875 |
| Exclusion of investment income on life insurance and annuity contracts | 720 |
| Real estate and other taxes deduction | 715 |
| Charitable contributions deduction | 700 |
| Deferral of capital gains on sale of principal residence | 640 |
| Exclusion of capital gains at death | 585 |
| Employee business and miscellaneous expenses deduction | 450 |
| Exclusion of miscellaneous fringe benefits | 195 |
| Exclusion of benefits provided under cafeteria plans | 190 |
| Exclusion of capital gains on residences for persons aged 55 and over | 175 |
| Contributions to self-employed retirement plans | 160 |
| Exclusion of compensation for injuries or sickness | 140 |
| Medical and dental expenses deduction | 120 |
| Carryover of net operating losses | 100 |
| Senior citizen credit | 95 |
| Exclusion of unemployment insurance benefits | 88 |
| Exclusion of employer contributions to life insurance | 58 |
| Contributions to IRAs | 56 |
| Los Angeles revitalization zone incentives[1] | 40 |
| Exclusion of employer-provided child care | 31 |
| Exclusion of scholarship/fellowship income | 31 |
| Manufacturers' investment credit | 30 |
| Exclusion of state lottery winnings | 27 |
| Exclusion of meals and lodgings furnished by non-military employer | 24 |
| Deduction for 25 percent of health insurance premiums | 20 |
| Moving expenses deduction | 20 |
| Research and development credit | 12 |
| Expensing costs of exploration, research, and development | 10 |
| Percentage depletion of mineral and other natural resources | 10 |
| Limited partnerships investment source rule | 10 |
| Low income housing credit | 10 |
| Subchapter S-corporations[2] | -135 |
| **Total** | **$13,222** |

[1] Prior Tax Expenditure Reports displayed the loss from zone credits only.

[2] The gain represents the net result after allowing for the pass-through of net business gains and losses to shareholders, as well as the impact of business source income to nonresident shareholders.

## Table Three



### Major Identifiable State Tax Expenditures of $10 Million or More, 1997-98—Dollars in Millions

| Sales and Use Tax[3] | Full Year Cost |
|---|---|
| Vessels and aircraft[4] | Unknown |
| Cargo and returnable containers[5] | Unknown |
| Custom computer programs | $ 169 |
| Partial exemption for vending machine sales | 50 |
| Motion picture production services | 28 |
| Printed advertising[5] | Unknown |
| Newspapers and periodicals distributed free of charge[5] | Unknown |
| Student meals[5] | Unknown |
| Watercraft common carrier fuel | 20 |
| Leases of motion pictures | 19 |
| Subscription periodicals | 10 |
| **Total[6]** | **$1,136** |
| Local government revenue loss (2.89 percent average rate)[7] | $657 |

3 5.00 percent General Fund rate.

4 Dependent on the volume of purchases that could be shifted out of state. The value of the sales tax exemption for vessels and aircraft is believed to in the range of $300 to $600 million annually. The value of the sales tax exemption for cargo and returnable containers is believed to be in the range of $100 to $500 million annually.

5 Believed to be in the range of $10 to $50 million annually.

6 Assumes a mid-range estimate for tax expenditures whose value is unknown.

7 Includes 0.50 percent Local Revenue Fund, 0.50 percent Local Public Safety Fund, 1.25 percent Uniform Local Sales Tax, and 0.64 percent average county add-on rate.

| Bank and Corporation Tax | Full Year Cost |
|---|---|
| Subchapter S-corporations | $900 |
| Carryover of net operating losses | 420 |
| Water's edge election | 390 |
| Manufacturers' investment credit | 315 |
| Research and development credit | 240 |
| Los Angeles revitalization zone incentives[8] | 154 |
| Corporations exempt from minimum tax | 94 |
| Expensing costs of research, exploration and development | 90 |
| Charitable contributions deduction | 40 |
| Exclusion of life insurance investment income | 37 |
| Percentage depletion of mineral and other natural resources | 30 |
| Enterprise zone/program area hiring and sales tax credits | 28 |
| Low income housing credit | 20 |
| Credit union treatment | 13 |
| **Total** | **$2,771** |

8 Prior Tax Expenditure Reports displayed the loss from zone credits only.

## Table Three

### Major Identifiable State Tax Expenditures of $10 Million or More, 1997-98—Dollars in Millions

| Other Taxes | Full Year Cost |
|---|---|
| **Motor Vehicle Fuel Taxes** | |
| Diesel and use fuel used by transit districts and schools | $21 |
| Aircraft jet fuel used by common carriers and military | 77 |
| **Total** | **$98** |
| **Insurance Tax** | |
| Nonprofit hospital service plans | $331 |
| Pension and profit-sharing plans | 26 |
| California Earthquake Authority policies | 30 |
| **Total** | **$387** |
| **Cigarette Tax** | |
| Sales to the military | $29 |

## Table Four

### Major Identifiable Property Tax Expenditures of $10 Million or More, 1997-98—Dollars in Millions

| | Full Year Cost |
|---|---|
| Open space, timber land, historical property | $133 |
| Computer programs | 101 |
| **Total** | **$234** |